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Multilateral Agreement On Investments (MAI)

A Critical Assessment From an Industrial Economics Point of View

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Multilateral Agreement On Investment (MAI)

A Critical Assessment from an Industrial Economics Point of View

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Abstract: Though the Multilateral Agreement on Investment (MAI) has failed, the original draft is likely to serve as a basis for future negotiations. This article gives a critical assessment of the draft from an industrial economics point of view. First, I summarize the contents of the agreement which is relevant for market structure and competition. Then I develop the industrial economics approach, which serves as a basis for criticism. I conclude that a multilateral agreement on investment should (i) recognize competition concerns, (ii) give a suitable definition of investment, and (iii) should help to establish competition authorities in less developed countries.

JEL: F02, F21, F23, L51

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1 Introduction

Negotiations on a Multilateral Agreement on Investment (MAI) within the OECD failed in 1998. This failure does not imply that efforts to regulate direct investment flows on a multilateral basis have come to an end. Instead, it can be expected that a general multilateral framework on investment will substitute for the multiplicity of existing bilateral agreements in the future.[1] The negotiations on the MAI indicate the form of such a future framework.

Several working papers present and criticize the contents of the MAI.[2] But an assessment from an industrial economics point of view has not yet been made. In the following, I will give such an assessment. I conclude that a comprehensive liberalization of direct investment flows only makes sense if strong competition authorities exist, which are able to ensure effective competition. In order to develop its positive effects also in less developed countries (LDCs), it is essential that a future agreement accompanies the implementation of effective competition authorities in these countries. Moreover, the term "investment" needs closer specification in a multilateral agreement. The MAI entirely ignores these aspects.

This article deals also with the question which institution should implement a future multilateral agreement on investment. The WTO and OECD play an important role in this context: Due to their high worldwide share of direct investment, OECD countries have a strong interest to liberalize investment flows. Up to now, the regulatory framework of the OECD comprise regulations concerning hidden investment barriers, the free flow of capital, and general guidelines for multinational enterprizes.[3] These regulations have three fundamental disadvantages: First, they do not cover all areas which are relevant for investment flows. Second, the agreements do not represent a real multilateral framework. They refer only to the member states of the OECD. Third, the contents of the agreements are not binding. Accordingly, the OECD has no effective dispute settlement body, which assures compliance to existing rules.

In contrast, the WTO can be regarded as a real multilateral organization. It contains two agreements that pertain to foreign direct investment: The

[1] Compare UNCTAD (1998a).

[2] Compare e.g. Hartwig (1999), Kozul-Wright and Rowthorn (1998), Polk (1999), Singer and Stumberg (1999).

[3] The existing regulations within the OECD refer to the "The Declaration on International Investment and Multinational Enterprises" (OECD 2000a), "The OECD Guidelines for Multinational Enterprises" (OECD 2000b), and the Codices of "Liberalisation of Capital Movements" (OECD 2001a) and "Current Invisible Operations" (OECD 2001b). Compare Polk (1999) for a detailed presentation of these OECD agreements. Investment related agreements of the WTO are also presented in this paper.

Agreement on Trade-Related Investment Measures (TRIMs) is an additional agreement to the GATT (General Agreement on Tariffs and Trade). It states that member countries of the WTO are not allowed to implement investment barriers which form a possible obstacle towards trade. The General Agreement on Trades in Services (GATS) also contains some minor investment related regulations.[4] But both agreements are limited to the scope of the WTO. A comprehensive regulation of investment flows, which is independent of trade political concerns, has not yet been established within the WTO.[5] I will argue that the WTO is a good forum for a future multilateral investment agreement.

This contribution has the following structure: Section 2 describes the regulations of the MAI which affect market structure and competition. Section 3 introduces arguments from an industrial economics point of view, which lead to my propositions in section 4. Section 5 discusses the WTO as a possible forum for a future multilateral agreement and concludes.

2 Presentation of the relevant MAI regulations

The basic contents of the Multilateral Agreement on Investment are:

- The National Treatment Principle.
- The Most Favored Nation Principle.
- Rules concerning protection of investors against expropriation.
- A dispute settling procedure.

Several authors discuss and critically evaluate the contents of the MAI.[6] I will restrict the following discussion to two important aspects, which concern competition policy.

Definition of the term "Investment"

[4]For an overview of these regulations, see Polk (1999). Grimwade (1996), Senti (1999), Trebilcock and Howse (1995) and WTO (1999) give a general overview of the regulatory framework of the WTO.

[5]The question whether a multilateral agreement on investment is generally desirable is not dealt with in this context. I will instead indicate which regulations should be altered if an agreement like the MAI is be installed in the future. For this approach compare also Ganesan (1998).

[6]Compare for instance Hartwig (1999), Polk (1999).

The definition of the term "Investment" determines the scope of the agreement and is therefore of great importance. The definition of the MAI does not differentiate between different types of foreign investment.[7] Strictly speaking, the agreement does not only cover direct investment, which involves a long term relationship and control of a resident entity in one economy.[8] Rather, scope is more general: It comprises any kind of engagement of a foreign investor. For instance, what defines an investment is independent of the question if the investor exercises control over the investment. Nor does it presuppose that the investor engages in a long term relationship. Stated positively, any investment which entails the economic performance of a natural or legal person falls under the scope of the MAI. Such activities include portfolio investments, which may be undertaken for short term gains or risk diversification purposes. Moreover, the acquisition of companies, shares or similar equities, debentures, intellectual property rights, licences or other movable properties also fall under the definition of the MAI. The same applies to investment which is related to the privatization of state owned properties, or for the allocation of concessions.[9]

Furthermore, the agreement does not differentiate between different kinds of foreign investment, as for instance acquisitions of firms, mergers, new foundations of plant locations, or acquisitions of minority stakes. The effect of an investment on market structure and the degree of competition depends much on its type: If a direct investment is made in form of a merger or an acquisition, it has different effects on competition than e.g. the foundation of a new plant location. Beside its type, the kind of control exercised with the investment plays an important role. If a foreign investment consists for instance of a cooperation in research and development activities (R&D), other welfare effects can be expected compared to a horizontal take-over of a competitor.

In sum, the definition of the term "Investment" in the MAI is too general. It does not differentiate between different forms of investments, between long term and short term engagements, and between different types of control. This is relevant for the effect on market structure and competition, as will be further laid out in section 3.

Effects on regional competition

The contents of the MAI weaken the bargaining position of governments towards multinational enterprizes. The common practice is that governments sanction concrete investment projects of foreign firms. The MAI forbids such individual concession procedures: It allows a country to stipulate general conditions for investments, as long as they do not discriminate foreign investors

[7] OECD (1998b), Section II, Definitions.

[8] For a close definition of foreign direct investment in this sense compare UNCTAD (2001), Annex B, A.2.

[9] OECD (1998a), Section III, Privatisation.

against domestic ones. The principles of national treatment and the most favored nation principle imply that a member state has to treat foreign investors in the same way as domestic ones. Individual investment requirements, which possibly imply a discrimination against other domestic or foreign investment, are forbidden.[10] This mechanism implies a complete and general opening of domestic markets for foreign investment flows.

This complete liberalization of investment flows does not only refer to engagements of MAI member states. Rather, it grants access investors from all countries, independent of their MAI membership. In addition, the treaty explicitly prohibits certain popular conditions on foreign direct investment, such as for instance local content requirements, minimum export contingencies or minimum expenditure requirements for R&D.

The MAI foresees one exemption to the principle of national treatment: Remember that the treaty forbids negative discrimination of foreign investors against domestic firms. But it explicitly permits positive discrimination of foreign firms. Positive discrimination is a preferential treatment of foreign investment vis a vis domestic firms. This rule, in connection with the most favored nation principle, implies a second rule. If a country grants a particular concession to a foreign investor, it is bound to grant this concession also to comparable investments in the future. These rules weaken the bargaining positions of national governments vis a vis investors essentially. I present the implications in the following section.

3 An evaluation of the MAI from an industrial economics point of view

Multinational enterprizes are present in oligopolistic markets, which are characterized by a high degree of market concentration.[11] The existence of transaction costs is crucial for the emergence of multinational enterprizes: If transaction costs in markets are high compared to transaction costs within the firm, firms gain through the internalization of trade within the firm organization, which promotes the emergence of multinational firms.[12]

Vertically integrated multinational enterprizes can be expected in markets where high switching costs between upstream and downstream firms exist. For

[10] OECD (1998a), Section III, National Treatment And Most Favored Nation Treatment.

[11] Compare Horstman and Markusen (1987), Markusen (1984) or Helpman and Krugman (1985).

[12] Dunning (1988), Chapter 1; Caves (1996), Chapter 4.

instance, search costs of firms reduce incentives to trade intermediate goods in a market. If a customer is not able to react to a change in market conditions within a suitable amount of time, the supplier may take advantages in negotiations. This may reduce a customer's incentive to trade the good in a market, and inefficiencies may occur. Internalization within a multinational enterprize can avoid such problems. Another reason for the emergence of vertically integrated multinational enterprizes is the importance of product specific investments, which may cause a hold-up problem: Suppose that an upstream and a downstream firm trade a good, the quality of which can be improved by a specific investment of the upstream firm. Both firms benefit from the investment. Now suppose that the upstream firm invests and both firms share the investment costs. Once the investment is done, costs are sunk. The downstream firm is then able to benefit from renegotiations. It knows that the investment is specific and its value to the supplier is small if the latter trades with other firms. Accordingly, the downstream firm can renegotiate and impose a higher degree of the investment costs on the upstream firm. But the upstream firm will anticipate this behavior ex ante, and its incentives to invest decline. As a consequence, it invests less than is socially optimal, and under investment results. A multinational enterprize may overcome this hold-up problem through the internalization of transactions and investments within a firm.

Horizontally integrated multinational enterprizes emerge in markets where non-tradable assets play an important role. These are for instance R&D intensive markets, or markets where organizational knowledge is a crucial factor. Horizontally integrated multinational enterprizes may also emerge in markets where marketing, brand names and the product mix plays an important role. These assets can not, or only to a smaller extent, be traded over markets. Internal organization within an enterprize may then provide a solution.

In sum, multinational enterprizes are mainly prevalent in oligopolistic markets where goods are diversified, or in markets where transaction costs within firms tend to be small. Market entry barriers must play an important role, or markets must be inferior institutions for trade of crucial assets. In contrast, if entry barriers do not exist, potential domestic competitors are able to enter the market; If trade upon markets is possible, the organization of trade within firms is unnecessary. In these cases, incentives to organize production in multinational firms are small.

3.1 Market Concentration and the Pursuance of Market Power

Multinational companies are present in oligopolistic markets. This indicates that an industrial economics point of view is appropriate to analyze the contents of the MAI: Which effect does a general liberalization of foreign investment have on market structure and concentration? In particular, does market concentration in host countries increase? And does increased market concentration imply that multinational enterprizes can exercise market power more easily? These questions are of interest, because a liberalization of foreign investment may increase market concentration. As a consequence, multinationals may exercise market power, which leads to negative welfare effects. But is this in fact the case? I discuss the relation between a liberalization of foreign investment, market concentration, and the exercise of market power in the following.

The relationship between market concentration and market power can be summarized as follows:[13] A high degree of *market concentration* exists if few companies have a high share of market demand. The existence of *market power* implies that companies take advantage of the high degree of market concentration. If market power is exercised, firms increase profits at the expense of consumers and aggregate welfare. A high degree of market concentration should therefore not be judged negatively per se. Only if a high degree of concentration leads to the pursuance of market power, allocative inefficiencies arise and aggregate welfare decreases.

Inefficiencies may arise in various forms: A company which exercises market power may be able to set prices above marginal costs, which increases profits. Compared to first best marginal cost pricing, equilibrium demand decreases and aggregate welfare declines. This may go hand in hand with a second way to exercise market power: If a firm realizes high markups and equilibrium demand is low, incentives to invest in cost reducing technologies may be small. The reason is that the benefit of the investment may be relatively unimportant if equilibrium demand is low. Moreover, a firm facing strong competition may also have higher incentives to invest in cost reducing technologies, because the cost reduction becomes more important if competition is strong. As a result, marginal costs may be excessively high if competition is low. In this case, firms underinvest in cost reducing-innovations, which decreases aggregate welfare. Higher costs leads to higher consumer prices, and demand and welfare decline. Thus, the pursuance of market power has negative welfare effects, irrespective

[13]Compare Neven, Nuttall and Seabright (1993), Chapter 2, and Tirole (1988), Chapter 5. Scherer and Ross (1990), Chapter 11, explain measures for market concentration, such as the Herfindahl-index and others.

of the specific form it is exercised.

However, a high degree of concentration does not necessarily imply that firms are able to exercise market power:

- If consumers can easily switch between different products, a high degree of market competition prevails, even if the number of firms is small. In this case, a single company is not able to influence the market result noticeably, because consumers substitute towards products of competitors in case of a price increases. Competition between firms tends to be tough if products are homogenous and consumers can easily substitute between them. If goods are heterogenous, substitutability tends to be small and firms find it easier to exercise market power.[14]
- Even though a single firm may not be able to exercise market power in a specific market, firms may be able to coordinate and exercise market power jointly. Competition laws forbid these practices, so explicit cartels are rarely found.[15] But firms may collude and exercise market power implicitly. This is more likely if the number of companies is small and the degree of concentration is high.[16]

Thus in itself, a high market share is not a reliable indicator that a firm exercises market power. High prices are more likely if market demand is inelastic, products are heterogenous, or coordination among firms is easy. But even then high prices may not necessarily prevail. Suppose that market entry is possible and potential competitors can enter the market at low costs. In this case incumbent firms cannot set high prices, because high profits makes entry more attractive, which increases competition. Accordingly, markups may be small even if market concentration is high. If a market is in fact contestable depends on several other factors beside low entry costs. For instance, suppose that the incumbent is able to adjust prices relatively fast in comparison to the time scale of the investment. In this case incentives to enter a market decrease, because the potential entrant anticipates that the incumbent will decrease prices as soon as he enters. In sum, whether a market is contestable depends on various factors beside entry costs, and should be judged case by case.

Finally note that a high market share and an increase of market concentration may result from successful investments. If a firm invests in cost reducing

[14] Neven et al. (1993) show how these rather theoretical concepts can be applied in reality. They introduce the concept of product specific "relevant markets", which describes the range of substitutes for a good under consideration.

[15] The OPEC is an example of an explicit international cartel.

[16] Bresnahan and Reiss (1991) indicate that coordination is not possible in markets with more than five firms.

technologies or demand increasing product improvements, demand may switch from competitors to that firm. The market share of the investing firm increases and concentration rises. Increased concentration is then not the result of welfare decreasing high markups, but welfare enhancing investments. Therefore, a high degree of market concentration may be an indicator that some firms are very efficient, rather than exercising market power. All these arguments indicate that a high degree of market concentration should not per se be considered as negative. One must decide case by case whether a high degree of market concentration goes hand in hand with the exercise of market power.

What is the effect of the MAI on competition? The MAI liberalizes foreign investment. Its effect on market concentration in the host countries is difficult to assess. Two opposite hypotheses seem plausible from a theoretical point of view: Multinational enterprizes may find it easier to overcome entry barriers compared to national firms, for instance because financial constraints are less binding. This tends to increase the number of firms in a market, and market concentration declines. If this is the case, liberalization of foreign investment increases competition in host countries, and the exercise of market power is less likely. Liberalization of foreign investment leads to less concentration. The effect of the MAI on market structure and aggregate welfare are then positive. As a second hypothesis, multinational companies may reduce competition in the host countries. This may be the case if multinational enterprizes drive out national companies due to technological advantages and the realization of scale economies. This increases efficiency on the one hand, but may also lead to a higher degree of market concentration on the other. As a possible consequence, firms may better exercise market power.[17]

It may be difficult to assess if the liberalization of foreign investment leads to more market concentration in general. As the following sections indicate, there may be differences between the short run and in the long run. But even if increased market concentration results from liberalization, one has to consider whether firms are able to exercise market power. This depends on market characteristics like demand elasticities, substitutability and the degree of entry barriers. This has to be assessed case by case.

3.2 Short Term Effects of Direct Investment

The last section contains two opposing statements about how a liberalization of foreign investment might affect market concentration. These statements do not necessarily contradict each other, because short run and long run effects of increased foreign competition may be different.

[17] Technological advantages lead also to lower costs, which tends to increase welfare.

In the short run, the type of foreign investment determines which concentration effects result. Unfortunately, only few studies deal with the question of which type of market access a multinational chooses, and how this choice affects market concentration in the short run.[18] I will distinguish two forms as polar cases, namely market access through merger and acquisition (M&A), and market access through foundation of a new plant locations.[19] These two types have different short run effects on market concentration indicates. Moreover, they are of great empirical relevance, because these two types account for a great share of today´s direct foreign investment.[20]

Direct investment as foundation of new plant locations reduce market concentration in the short run. New market participants enter the domestic market, which increases the number of firms and competition. In contrast, mergers and acquisitions may increase market concentration. Whether this is the case depends on different factors and has to be examined case by case: Suppose that a foreign investor acquires a domestic firm. The effect on market concentration depends on the relationship between the investor and the takeover candidate before the acquisition. If the domestic company competes with the exports of the acquiring firm, the acquisition leads to reduced competition and increases market concentration. If in contrast the domestic firms do not compete with exports of the investor, market concentration is not affected. It may even decrease. Consider for instance the case where firms in the domestic market are heterogenous: The acquired firm is small compared to its competitors and lacks productivity in the domestic market without the investor. The acquisition may then lead to a transfer of know how and new production skills, which increases productivity and the size of the acquired company. Thus mergers and acquisitions may increase competition even in the short run.

The effect of foreign investment on market concentration and competition depends on the type of investment and specific market conditions. But which type of investment do companies chose? This question is subject to further research. Existing studies (compare footnote 18) indicate that the following factors plays a role: If speed of entry plays an important role, firms prefer foreign investment as mergers and acquisitions. This is also the case if firms intend to stay close to a market competitor, who is already present in a market which is strategically important. In contrast, cultural differences between

[18] Compare Walter (1993), Buckley and Casson (1998), Hennart and Park (1993), Caves and Mehra (1986) in the context of multinational enterprizes. General industrial economics approaches towards mergers and acquisitions and their effect on market structure and welfare are for instance Ordover, Saloner and Salop (1990), Barros and Cabral (1994) and Aydemir and Schmutzler (2002).

[19] Other types are for instance licensing or franchising.

[20] Friedman, Gerloski and Silberman (1992), UNCTAD (1998b), and UNCTAD (2001), p. xiii.

the acquiring and the acquired firms tend to increase the costs of a merger. Accordingly, if cultural differences play an important role, direct investment as foundations of new plant locations are more likely.

3.3 Long Term Effects of Direct Investment

Long run effects of the MAI on market concentration depends mainly on two aspects. First, multinational companies may be able to drive national firms out of markets. Moreover, multinationals may find it easier than domestic firms to erect market entry barriers.[21] The empirical evidence is ambivalent:[22] Foreign investment in industrialized countries tends to decrease market concentration in the long run. Competition increases through direct investment, which indicates that the MAI has positive welfare effects in these countries. In contrast, foreign investment in less developed countries (LDCs) leads to an increase of market concentration in the long run. Multinational companies tend to drive national companies out of markets. This is due to technological advantages and the use of scale economies. Accordingly, the welfare effect of a broad liberalization of foreign investment in LDCs is difficult to assess. Market concentration and the exercise of market power may increase, which tends to decrease aggregate welfare in these markets. On the other side, productivity improvements lead to lower costs and reduce prices, which tends to increase aggregate welfare.

A second aspect relates to the exercise of market power. The broad liberalization of foreign investment through the MAI may have positive welfare effects, even if the market structure does not change in a specific country. This is a contestable market argument: Suppose that the MAI does not induce more foreign investment in a certain country. It may nevertheless improve aggregate welfare there, if multinational companies overcome market barriers easier than national companies. The mere threat to enter a market may be sufficient to induce competitive pricing. In this case, prices decline and aggregate welfare improves, even though the market structure remains the same. Empirical studies show that the aspect of contestable markets may play an important role.[23]

[21] For instance, multinationals might use transfer prices to collect profits in regions with small taxes, which gives them strategically advantages over national firms.

[22] Compare Dunning (1974), Kumar (1990), Ratnayake (1999), Lall (1979), Petrochilas (1989), Jenkins (1990).

[23] Compare Shapiro (1983), Geroski (1991).

3.4 Competition for Direct Investment

Governments often try to influence the location decision of companies. They grant subsidies or loopholes for specific regulations, which tends to decrease taxes or costs. As stated in section 2, the contents of the MAI imply that regional competition increases. Foreign investors improve their bargaining position against national governments. The question arises if the induced intensification of regional competition through the MAI improves aggregate welfare.

The following model by Rauscher (1995) gives a basic intuition how regional competition effects aggregate welfare.[24] It analyzes strategic interactions between a single multinational enterprize and representatives of various identical regions. The multinational serves all regions, creating a consumer surplus in each region that is independent of its production location.[25] In each region, market demand and cost conditions are identical, except possibly for emission taxes, which increase variable costs (and thus reduce the supply of the good). Emission taxes are set by each region in the first stage of the game, because production causes pollution, which is strictly local. That is, environmental damage occurs only in the host country of the enterprize. Environmental damage is the same in each region. Jurisdictions maximize welfare, which consists of the sum of local tax revenue and local consumer surplus minus local environmental damage. The multinational decides about the production location in the second stage of the game, which is the region with the lowest taxes. Finally, the multinational serves all regions from the local production plant.

The basic insight of this model is that, even in the absence of global environmental pollution, different market equilibria may emerge. The reason is that environmental damage and tax revenues arise only in the host country, whereas all countries realize consumption rents. We restrict the analysis to two polar cases, which I entitle as "strong regional competition" and "not-in-my-backyard"-politics. In the first case, countries opt for lax environmental regulation to attract the investment. Strong regional competition exists, and environmental regulation is too small. In the latter case, no region wants to bear the burden of local environmental pollution, even though production in general is desirable. When do these cases arise?

Strong regional competition arises if local environmental pollution through

[24]The following description follows the survey on regional competition by Schmutzler and Polk (2001) closely. Janeba (2000) provides an analysis which combines the view that multinational companies benefit from regional competition, with the idea that governments may potentially exploit multinationals once an investment has been made. Compare also the quoted literature there.

[25]The model assumes away transportation costs.

production is very small. In this case, tax income from local production outweighs the welfare effect of environmental pollution. Accordingly, each country is interested to win the competition for the plant decision. As only the country with the lowest regulations gets the foreign investment, all countries face incentives to lower regulation. Strong regional competition results, which leads to inefficient under regulation of the firm. On the contrary, if environmental pollution is very high, disadvantages from local production exist. In this case, tax revenue and domestic consumer welfare are not enough to outweigh environmental pollution from local production. Each country sets high emission taxes to deter local production. As all the countries employ this "not-in-my-backyard"-behavior, no production takes place in any region and consumer welfare will not be realized. A prisoners' dilemma results: Due to strict regulation, no investment takes place, even though production is desirable from an aggregate welfare point of view.

As the preceding model indicates, regional competition is efficient with respect to the location decision of the multinational firm. The firm invests where environmental regulation is small, which minimizes tax payments. But the extent of regulation is inefficient. Regulation tends to be too strict if environmental pollution is high. If it is low, strong regional competition emerges and regulation tends to be too low. This result, namely efficient regulation with respect to the location decision, but inefficient regulation with regard to allocative aspects, is relatively robust to variations of the theme.

The MAI intensifies regional competition, which tends to decrease allocative efficiency. In contrast, locational efficiency improves. In reality, these two effects have to be weighed against each other, which may be subject of further research.

4 Propositions for a new MAI

I will develop three theses in this section:

- Foreign investment affects market structure and competition. A multilateral agreement on investment needs to consider these effects. It can either implement own competition rules, or explicitly state the primacy of national competition laws.

- If a future agreement implements regulations on competition policies, the term "Investment" needs more careful specification.

- A far reaching liberalization of foreign investment flows can only exhibit its positive effects on growth, productivity and employment, if all countries have well functioning competition authorities. A multinational agreement on investment should only be implemented, if it includes active support for the creation of competition authorities in all countries, especially in LCDs.

Before I justify these theses, let me first state that the higher degree of regional competition has no negative consequences in my opinion: I discussed theoretical approaches concerning the effect of foreign investment on competition between regions in section 3.4. The discussion concluded that no clear statement can be made about the effect of increased regional competition on aggregate welfare. Suppose that further research indicates that tough regional competition reduces aggregate welfare. Even then no argument in favor of discrimination of foreign investors should be deduced. The MAI prohibits discriminating behavior against foreign investors, but not a general prohibition of certain types of investment. Accordingly, a country may impose general investment regulations if it turns out that regional competition is bad. The binding condition is that these affect foreign and domestic firms in the same way. For instance, a government might impose a regulation which restricts the maximum amount of investment subsidies, or it may prohibit the construction of new sites for nuklear energy. These types of regulation are allowed as long as they affect domestic and foreign investors in the same way. They are only prohibited if they lead to discrimination of foreign investors against domestic ones. And to my point of view, nothing is bad about this particular prohibition of discrimination.

In addition, the MAI foresees a rule which implies that once granted subsidies must be open to all investors in similar situations in the future. This rule increases the cost of a singular subsidy substantially, because a country must consider its expected future cost. If competition between regions turns out to be bad, the implied higher costs of subsidies through the MAI tend to reduce these inefficiencies. In sum, even if increased regional competition turns out to decrease aggregate welfare, this should not be used to deduce arguments for discriminating behavior against foreign investors.

4.1 Integration of Competition Policy Aspects

The detailed effects of a liberalization of foreign investment on market structure and concentration depend on the specific circumstances in which foreign investment is carried out (compare chapter 3). But it is undebatable that a broad liberalization of foreign investment affects market structure and competition. Hence a multilateral agreement should consider competition policy concerns. It should be open to rules which prevent negative competition effects in the member states, which may be induced through the general liberalization of foreign investment flows. The draft of the MAI lacks such an approach.

The form of integration is debatable. The question is whether competition rules should be explicitly integrated in such an agreement on a multilateral basis. Or is it preferable to foresee a clause which acknowledges the primacy of national competition laws, but leads the implementation and integration of these rules to the member states? This question is subject to current debates.[26]

Consider for instance the following argument in favor of central competition policy rules. The existence of multinational enterprizes leads to interdependencies between national competition policies, which gives incentives to set competition policy strategically: A national government is interested to assure strong competition in its domestic market, which maximizes national welfare. But suppose that this country is the host of a multinational enterprize, which produces in a foreign country. Moreover, suppose that its profits can be transferred to the home country. Then the country benefits from relatively lax competition in the foreign country, which increases profits there. Accordingly, if countries have asymmetric political strength, countries may face incentives to implement different standards of competition policy in different regions. Welfare reducing distortions in the product markets can then be expected.[27] This is an argument in favor of a central competition authority within the MAI. But there are also arguments against it: It may be easier for interest groups to influence a single central authority compared to several national ones, as Laffont and Tirole (1993) indicate. Moreover, a central authority eliminates competition between institutions, which may not be desirable.

If the member states decide to centrally implement competition rules in the agreement, concrete laws need to be worked out. Moreover, member states must agree to implement an effective dispute settlement body, which promotes the factual realization and accordance to these rules. Effective punishment measures are crucial, otherwise the body would degenerate to a tiger without teeth. On the other side, if the agreement includes rules on competition policies at a decentral basis, competence for legislation and implementation remains with the authorities of the member states. The agreement should then foresee a primacy of competition concerns about the liberalization of investment. The formulation, implementation and execution of concrete competition laws would then be left to the authorities of the member states.

[26]Compare for instance Basedow (1998), Rosenthal and Nicolaides (1997), Härtel (1999), Barros and Cabral (1994).

[27]Caves (1996), Chapter 4; Empirical references can be found in OECD (1974).

4.2 Specifying the meaning of "Investment"

As sections 3.1 to 3.3 indicate, the effect of foreign investment on market structure and competition depends on its type. Accordingly, a multilateral agreement on investment needs to differentiate between different types of foreign investment. The definition of the term "Investment" in the MAI is too general. For instance, the agreement treats portfolio investment in the same way as traditional direct investment. These two types have different characteristics, as portfolio investment are made on a short term basis, and risk diversification plays a crucial role. Portfolio investments entail stability risks for the receiving country, and affect corporate planning in a different way as long term direct investment.[28] In contrast, portfolio investments do not affect market structure and competition, which direct investment does.

Long term oriented direct investment affects market structure and competition in the receiving and the host countries, which should be considered in a multilateral agreement. If a future agreement foresees the primacy of competition laws upon the liberalization of investment flows, but leaves the implementation to the member states, a broad differentiation of the term "Investment" seems suitable. However, if the agreement will explicitly integrate corresponding regulations on a multilateral basis, the term "Investment" needs much more detailed differentiation in order to comply with the different effects of various investment types. As explained in section 3.2, e.g. mergers has other effects on market structure and competition, as the creation of new plant locations. The very far-reaching and general definition of the MAI does not allow such a differentiation. It should be extended accordingly.

4.3 Promotion of Competition Authorities in LDCs

I discuss possible negative effects of foreign direct investment on LDCs in section 3.3. The analysis hints at the increasing importance of well functioning and efficiently working competition authorities. A multilateral agreement serves to liberalize direct investment flows, with the aim to increase competition. The framework must assure that these positive effects can in fact be realized. This is not the case if increased liberalization leads to less competition. In this case, the MAI may create negative effects on market structure and competition, which decreases aggregate welfare especially in LDCs. Accordingly, the implementation of a multilateral agreement on investment should only be undertaken, if it simultaneously promotes the establishment of efficient competition authorities in LDCs.

[28]Some economists propose a tax on short term capital transactions. Compare Tobin (1978), Frankel (1996).

If an agreement foresees that competition policy remains in the hands of the member states, it should be considered that many LDCs lack well functioning competition authorities.[29] To guarantee competition in these countries, a multilateral agreement should then promote the implementation of well functioning competition authorities in LDCs. If this is not the case, negative effects on market structure and competition may result in less developed countries. Positive effects on growth and development may be weakened in these countries, and even be converted into a negative welfare effects.

5 Is the WTO a suitable forum for a future Multilateral Agreement?

If a multilateral agreement on investment will be implemented in the future: What is a suitable forum for its realization? The OECD is not appropriate for two reasons: First, it seems rather unlikely that the OECD resumes negotiations after its first failure. Second, the limited sphere of influence of the OECD speaks against this organization, as it does not represent the group of less developed countries.

The WTO can play an important role for the integration of such an agreement.[30] It already has an extended mandate beyond the field of international trade in some respects. It touches the fields of direct investment, trade and competition policy, in as much as these fields are linked to questions of international trade policy. Therefore an integrative and broad approach to regulate these associated fields within the WTO seems reasonable.[31] Consider for instance the recent negotiations between China and the European Union for a Chinese entry into the WTO. Access to the Chinese telecommunication market was of special interest to the EU. So the countries agreed that European companies are allowed to purchase minority stakes of Chinese telecommunication companies of up to 49%. Remarkably, this WTO agreement essentially regulates the liberalization of foreign investment, and does not exclusively refer to mere trade policies.

The WTO has also established structures to elaborate, realize and integrate multilateral agreements. The dispute settlement mechanisms are relatively effective. Recently, the settlement body accomplished that member states abide to the contents of the WTO agreements.[32] A dispute settling mechanism must

[29] Compare Basedow (1998).

[30] For argument in favor of an implementation within the WTO, compare Ganesan (1998). Arguments against an implementation gives Hartwig (1999).

[31] Compare also OECD (1999a), OECD (1999b).

[32] Information on current and past proceedings can be found at

be integrated into a multilateral agreement on investment. As its effectiveness is crucial for a good implementation, the WTO appears to be a suitable platform.

Another advantage is that less developed countries are represented within the WTO. Of course, their political weight and their representation in working groups is not comparable to the US, the EU or Japan. This should be improved with a multilateral agreement on investment, such that all countries are in fact able to coordinate own interests and bring them forth within the WTO. Other forums, as for example the UNCTAD, would probably better represent the interests of LDCs. But it would be doubtful whether the member states of the OECD agreed to such a forum.

A transfer of the MAI to the WTO generates political costs. For instance, members of the OECD and the WTO face different interests, as Hartwig (1999) argues. But this is not an argument that an agreement should be restricted to the OECD. If an agreement on investment is ever going to be implemented, the WTO appears to be the right organization to deal with it.

http://www.wto.org/english/tratop_e/dispu_e/dispu_status_e.htm.

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